Innovative Mechanisms in Housing Finance for Low-Income Applicants: A Background Paper

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Preface

This paper was written in response to a request from USAID's Office of Urban Programs in Washington and the USAID Regional Housing and Urban Development Office in Pretoria. It looks at innovative housing finance mechanisms in economies roughly similar to South Africa's, with an emphasis on mortgage products from commercial lending institutions.

Introduction: Adapting Loan Conditions for Low-Income Borrowers

Obtaining housing finance is particularly challenging for low-income people in developing countries. Shortages of housing and lack of a commercial lending system are two of the most common obstacles. But even in the absence of these impediments, low-income borrowers often face additional challenges: lack of collateral, lack of funds for a downpayment, and inadequate savings institutions. This paper surveys innovative methods that have been used to address some of these issues.

The U.N. Centre for Human Settlements (UNCHS) published a menu of methods (UNCHS 1990) for adapting loan conditions to low-income borrowers. This paper will expand on several of these methods, which include:

1. A graduated payment mortgage enables a borrower to pay a reduced installment in the early years, which gradually increases over the term of the loan. It defers amortization to the last years of the mortgage.
2. Forced savings plans and low downpayments overcome the problem of low savings and increase eligibility.
3. Leasing, rent-to-own, and hire-to-purchase schemes help overcome the collateral issue because the developer or lender retains title until repayment of loan is complete.
4. Government agencies can provide loan guarantees or loan insurance.
5. Issuing group loans to groups of households or cooperatives (much like microlending's village group loan methodology) reduces the risk of defaults. The group repays the loan and organizes collection from members.
6. Incremental loans—multiple, small, short-term loans—enable homeowners to improve or expand their home a step at a time. Loan amounts conform to the income of the borrower at the time (UNCHS 1990, pp.44-5).
7. Loans granted to low-income borrowers enable them to expand their house for rental purposes. An additional room adds to the housing stock and could be rented to other low-income families. The rental income would assist with the loan repayment, thus the loan becomes self-liquidating (UNCHS 1990, p. 46).
8. Securitization can transform illiquid, risky assets into negotiable, liquid instruments with low-credit risk.
9. A lottery system can reward those current on repayment. The lottery is open only to those up to date on their mortgage payments. Chile has used this method.

Subsidies

Interest Rate Subsidies

The U.S. Department of Housing and Urban Development (HUD) operates an interest rate program termed "Section 235," which

(1) subsidizes mortgage payments by reducing the effective interest rates and
(2) provides mortgage insurance to the lender.

Higher income households receive smaller subsidies. The subsidy payment is the difference between the full housing payment and 20 percent of the buyer's income. The subsidy does have a cap; Section 235 will not lower the interest rate below 4 percent. There is also a limit on the size of a mortgage, above which the purchaser must contribute toward a higher downpayment. This restriction limits the government's cost and also ensures that the family will be able to afford the costs of maintaining the home. Purchasers qualify for Section 235 solely on the basis of income; assets are not considered.[1] The downpayment required is 3 percent of the purchase price, which may include closing costs. A buyer can reduce the downpayment through labor on the house (Daniell 1992, pp. 9-10).

Section 235 has experienced a high default rate, which has been addressed by raising the downpayment and income requirements. But this solution has also steered the program toward middle-income rather than low-income clients (Daniell 1992, p. 11).

End-of-Term Subsidies

A solution to the challenge of sustaining the flow of funds in an inflationary environment is an *indexed mortgage contract*. For lenders, it is a way to preserve the real value of the repayments over the loan maturity. For borrowers, indexation can reduce the large payment burden in the early years of the loan and may prevent them from being locked out of the housing market by cash flow constraints (Buckley 1989, pp. 8-12).

In 1989, the Housing Development Authority of Turkey began to offer *dual-indexed mortgages* to distribute risk between borrowers and lenders. The loan balance is indexed to a measure of inflation to protect the lender from erosion of the loan value. Payments are indexed to some measure of wages in order to make the loan affordable to households. In circumstances where real wages are falling, households would not be required to make the full payment of principal; the unpaid portion is capitalized into the outstanding balance. Because the real repayment rate varies, the loan term is flexible. When the maximum term of the loan is reached, the outstanding loan balance is forgiven, resulting in an end-of-term subsidy to the borrower if real wages have continued to fall (Daniell 1992, p. 12).

[1] Exception: Section 235 cannot be used for a second home.

Downpayment Subsidies
The Chilean Ministry of Housing (MINVU) offers downpayment subsidies of up to 75 percent of the housing cost for either existing housing or new construction under the Basic Housing Program (BHP) for qualified low-income buyers. Housing is divided into three levels according to cost, with level 1 being the lowest cost and level 3 the highest. The government grants an explicit subsidy by discounting up to 75 percent of the unit cost; the remainder is financed through participants' savings and a 12-year mortgage carried by the ministry for level 1, and by private mortgages for levels 2 and 3 (Daniell 1992, pp. 13-14). The mortgage contract is in an indexed monetary unit,[2] with terms similar to commercial mortgages (Nassau 1989, p. 18).

In Chile's Allocating Subsidy Certificate Program (ASP), beneficiaries earn points based on prior savings, subsidy requested, and income level. Instead of contracting the construction of units, MINVU distributes subsidy certificates to those with the most points. The home buyer then arranges for private financing, using the certificate as a cash voucher. ASP certificates may not exceed 25 percent of the unit cost, and many are for smaller amounts (Persaud 1992, p. 14).

Both of these Chilean programs have suffered from high mortgage arrears, and frequent debt renegotiation and various initiatives to increase repayment have not had the desired effects. The ASP program has not been able to attract sufficient commercial lenders despite loan guarantees, and the government has had to step in. The quasi-governmental bank that made most of the ASP loans now faces a substantial arrears problem (Persaud 1992, p. 15).

A contradictory outcome of Chile's Basic Housing Program is that private, independent contractors are reluctant to undertake construction of low-income housing on their own. The government's contracting system has made it much more attractive to be a government contractor than an independent developer, especially since the market for low-income housing prices units at 75 percent below production costs (the amount of the government subsidy) (Persaud 1992, p. 15).

Types of Loans
The *conventional mortgage loan* is characterized by a) equated repayment installments, usually monthly; b) fixed interest rates for the loan duration; c) long terms of 15 to 30 years; d) requirement of free land title or long-term lease; e) requirement of approved formal housing; f) debt entry into land registers; and g) minimum loan size (UNCHS 1990, p. 40).

The *graduated-payment mortgage*[3] allows for reduced installments during the early years.

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[2] The Unidad de Fomento, or UF.

[3] Also known as a progressive loan.

The low installment in the early years rises at a fixed rate per year, which defers amortization to the last years of the mortgage. During the first years of the mortgage, payments sometimes do not cover the interest due, so the outstanding loan balance actually increases (UNCHS 1990, p. 40).

Variable- or adjustable-rate mortgages cause the borrowers to experience steep rises in installments when the interest rate rises rapidly. To mitigate this effect, the lender may increase the loan term instead of increasing the installment. This type of loan enables the financial institution to stabilize the relationship between the cost of the fund and the loan portfolio yield. Kenya was one of the first developing countries to use this type of loan (UNCHS 1990, p. 41).

Loans of reducible duration accelerate the recovery of the principal through annually increased repayment. The annual increments are designed in such a way that the repayments of borrowers do not increase in real terms because the rate of increase of the annual installment is linked to the rate of increase of the income of the target group. Moreover, because of inflationary environments, the real value of the amortization decreases in line with the inflation rate. Interest payments are often less than in a conventional loan, and the principal is recovered more quickly (UNCHS 1990, p. 41-2).

India's Mortgage Loan Program

The Mortgage Loan Program is the core of Housing Development Finance Corporation (HDFC) lending. Interest rates vary with loan size (12.5 percent to 14.5 percent), with larger loans carrying larger interest rates. The term is 15 to 20 years, and maximum loan-to-value ratio is 85 percent. The monthly payment-to-income ratio averages 25 to 30 percent, and up to 40 percent for certain borrowers (Buckley 1989, p. 16).

A graduated Step-Up Repayment Facility Lending Program, in which monthly payments are raised during the course of a 15-year loan, represents a growing share of individual mortgage lending. HDFC has also introduced a Telescopic Loan Program, in which an initially extended mortgage term is reduced (and monthly payments rise) as the borrower's income increases. The Home Savings Plan, designed to encourage regular monthly savings, provides an interest earning of 6 percent a year and a low-interest (8.5 percent) loan of an amount up to 2.33 times the amount of savings accumulated after a period of 25 to 84 months (Buckley 1989, p. 16). Total front-end fees are controlled at 2 percent or less of loan amounts (*Housing Guarantee* 1992, sect. 4.3).

Refinancing
To encourage private sector loans to low-income homebuyers, India's National Housing Bank provided 100 percent refinancing for loans up to Rs. 50,000 for the purchase (or construction) of units up to 40 square meters or Rs. 30,000 for upgrading or major repairs. Rural homes were exempt from the 40 square meters rule (*Housing Guarantee* 1992, sect. 4.3).

Zimbabwe
The government of Zimbabwe, in collaboration with UNCHS, USAID, and the Beverly Building Society, has developed a unique housing-finance program for low-income families in two rural areas (Boleat 1987, p. 166). The Ministry of Construction and National Housing provided 1,000 fully serviced plots[4] in KweKwe and 200 in Gutu to selected beneficiaries below the median income. The beneficiaries are eligible for a housing loan based on their ability to pay. They were also encouraged to mobilize their own resources toward building their homes and to make improvements on their homes within a specified time. USAID provided a grant for the capital financing, which was matched one-to-one by the Beverly Building Society.

The building society received some guarantees and less stringent reserve requirements in return for its participation. A homeowner's labor—in managing the self-construction process—was considered part of downpayment. The mortgages carried a six-month grace period, and loans to mature applicants were subject to the 70-year rule (age of applicant + loan maturity = no greater than 70 years). Inexpensive life insurance was built into each loan (0.1 percent p.a.) (*Zimbabwe Urban Development Project Performance Audit Report* 1996, pp. 19-20).

Housing Savings Schemes
In Germany's Bausparkassen, savings contracts run over a number of years, usually three to five, with a fixed savings goal (Renaud 1984, pp. 82-3). The depositor is promised a long-term loan, normally three times the amount of the contracted savings at a low interest rate. Although the savings earn low interest, the tax-deductibility of the annual contributions (up to a certain limit) helps make this scheme attractive. Also, a bonus is paid on the annual savings. In the early 1990s, Bausparkassen financed 20 percent of Germany's new housing (UNCHS 1990, p. 33).

In India, the Housing Development Finance Corporation introduced a Home Savings Plan modeled on Germany's Bausparkassen. People are encouraged to save over a period of time in a contractual plan, which involves a specified savings amount at 6 percent of the contracted total per year. At the end of the savings period, the individual becomes eligible for a housing loan of the contracted amount at a predetermined interest rate (8.5 percent). As the

[4] The plots have access to water, sewage, roads, electricity, and community facilities.

savings period is considerably shorter than the loan period and the amount of savings is less than the amount of the loan, the saver benefits because of the low-priced loan (UNCHS 1990, p. 33). In a variation of this program, households that save consistently over a period of years will benefit from National Housing Bank refinancing of their loans based on a multiple of what they saved (*India—Housing Development Finance Corporation Project* 1992, pp. 10-11).

France established a savings-for-housing scheme in 1965—the Compte d'Epargne Logement (CEL)—and, four years later, a second—the Plans d'Epargne Logement (PEL), both featuring tax exemptions on interest earned and a bonus from the government of 3.5 percent or 3.7 percent, which almost doubles the yield. The two types differ in the ability to withdraw funds (easier with CEL), in the level of interest on deposits and loans, in loan and savings ceilings, and in the ratio of loan offer to accumulated savings (4.5 for CEL and 2.5 for PEL). By 1983, 9.5 million accounts had been opened with total net outstanding savings of FF222.8 billion, of which 51 percent had been lent for housing (*Housing Guarantee* 1992, sect. 4.3).

Conclusion

Home ownership has traditionally been a privilege of middle- and high-income people. To obtain a mortgage, one usually has to have collateral, a good credit history, guarantors, and a stable income. Low-income people often have difficulty meeting these requirements. But in developing countries, a mortgage market often does not exist. Home purchases are often cash transactions, and middle-income parents tend to buy homes for their children, often late in life, after many years of savings. In the absence of a mortgage market, home ownership is virtually impossible for low-income people.

Specially designed housing finance mechanisms offer the only hope for this segment of the population. And in this respect, low-income people in developing countries and the industrialized world are quite similar; they face comparable impediments to home ownership. Thus Germany's housing finance savings scheme was replicated in India with only minor adjustments.

By designing housing finance mechanisms that address the most common impediments faced by low-income borrowers, the projects discussed above demonstrate that small adjustments in lending procedures may enable more people to achieve home ownership in the developing world. And increases in home ownership enhance not only economic growth but also may contribute to civil society. People who own a stake in their community are more likely to become involved in all aspects of it.

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Note: For additional information on any of the topics discussed in this paper, or to receive copies of any of the articles listed in this bibliography, please address your request in an e-mail to CDIE_Info@CDIE.RRS@AIDW.

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